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THE POLITICS OF FAIR VALUE REPORTING AND THE GOVERNANCE OF THE STANDARDS- SETTING PROCESS: CRITICAL ISSUES AND PITFALLS FROM A EUROPEAN PERSPECTIVE

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THE POLITICS OF FAIR VALUE REPORTING AND THE GOVERNANCE OF THE STANDARDS-SETTING PROCESS: CRITICAL ISSUES AND PITFALLS FROM A EUROPEAN PERSPECTIVE

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ABSTRACT: Accounting is not simply a metric; rather it is a calculative practice which shapes the socio-economic environment. Therefore, looking only at the substance of accounting standards is sometimes inadequate.

From a European Union perspective, this paper provides a general framework that deals with the potential changes in society produced by financial reporting. More specifically, it discusses fair value reporting from two points of view, which are strictly linked. The first relates to the politics of fair value accounting and its potential impact on the economic and social system, while the second relates to the governance of the standards-setting process.

Financial regulation is one of the competencies of the European Union. Therefore, this paper claims that controversial issues in financial reporting should be examined in the framework of the Lisbon Treaty, which sets out the fundamental principles on which the European Union has decided to build and shape its future.

KEYWORDS: Financial Reporting, IFRS, Fair Value, IASB, European Regulation 1606/2002, EFRAG, Lisbon Treaty

JEL CLASSIFICATION: M40, P00, K00

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1. INTRODUCTION

Financial reporting is not a neutral, mechanical and objective process that simply measures the economic facts pertaining to a firm. It is rather a powerful calculative practice, which is embedded in an institutional context and shapes social and economic processes. Deconstructing the influence of technical accounting standards reveals that accounting normalizes and abstracts a “system of socio-political management” (Miller and O’Leary 1987). Therefore, considering accounting standards independently of their social context, as we normally do as accounting scholars, is sometimes inadequate.

Mainstream accounting research usually investigates standards in terms of their efficiency, principal-agent conflicts, and information asymmetry. This paper, instead, adopts a broader view which considers financial reporting issues in terms of their potential effects on socio-economic systems. More specifically, it focuses on fair value reporting and, while doing this, it adopts a European Union perspective. Fair value accounting is being extended in the international accounting standards IFRS¹ adopted by the European Union in 2005. Although - at present - European Regulation requires only publicly-listed companies to use IFRS for their consolidated financial statements, some member states have extended their use to other entities and/or annual accounts. Fair value accounting is therefore a key issue in the European Union’s financial reporting regulation. There is also a clear intent on the part of the IASB to push for extending IFRS to unlisted firms, with the specific purpose of avoiding inconsistency within the accounting practices of individual countries in the European Union (IFRS Foundation 2013).

This paper discusses the politics underlying fair value reporting and the changes it can induce in the socio-economic environment. Furthermore, it critically examines the institutional organization of the standards-setting process.

The starting point of the discussion is the definition of fair value as an exit price provided by IFRS 13. Many scholars have argued that fair value accounting based on spot market prices contributes to the procyclicality of the financial system (e.g. Plantin *et al.* 2008), while others have raised several concerns on the reliability of fair value estimates based on valuation techniques (e.g. Benston 2008, Ryan 2008). Some others have instead highlighted that a fair value definition as an exit price is misleading for assets that are

¹ For ease of exposition, the term IFRS is used to refer to both the International Accounting Standards (IAS) and to the International Financial Reporting Standards (IFRS). IFRS are issued by the International Accounting Standard boards (IASB), whereas IAS were issued by the International Accounting Standard Committee (IASC), predecessor of the IASB until 2000.

held for a long period and, in particular, to maturity (e.g. Whittington 2008, Allen *et al.* 2009b).

This paper claims that the spread of fair value reporting and its definition as an exit price is integral to the financialization of the economy, which shifts power from production to finance and considers shareholder value as a central feature of corporate governance, thus encouraging short-term perspective on profit (Epstein 2005). Such a focus on finance, at the expense of production, may exert disruptive effects on the so-called Rhenish economies (Hall and Soskice 2001). In many countries of the European Union, including Germany, Denmark, Sweden and France, shareholder wealth maximization has never been the sole goal of executive boards. Economic processes have been characterized for the most part by a collaborative relationship between labour and capital, the availability of patient capital provided by the bank system and a long-term perspective on decision-making, which have all been crucial for maintaining the Rhenish competitive advantage of using highly skilled labor to produce high quality, and often specialized, products (Nölke and Perry 2007). In this respect, fair value reporting may lead to a structural change in the relationship between managers, financiers and wage earners and, in the end, in the economic regime itself (e.g. Martinez-Diaz 2005, Perry and Nölke 2006, Botzem 2012). This is a key issue even only in economic terms, as the so-called stakeholder model of governance typical of the Rhenish economies is deemed to improve efficiency, reduce the probability of failure, and increase firm value (Allen *et al.* 2009a).

Furthermore, this paper considers the institutional organization of the standards-setting process, which is oriented towards an increasing use of fair value in financial reporting². By choosing to adopt IFRS, the European Union has delegated the standards-setting process to a private authority, the IASB, which is characterized by a skewed distribution of its members in favor of the financial industry (e.g. Crawford *et al.* 2013). The same holds for EFRAG, which assists the European Commission in the IFRS endorsement process within the European Union. Other types of stakeholders, such as companies from the manufacturing industry, domestic regulatory agencies or labour unions, instead, are not involved in the process. Given a tight link between the structural power of the financial industry within standards-setting bodies and the increasing use of fair value in financial reporting (Ramanna 2013), this is a key issue which must be approached carefully.

² For instance, IFRS 9, *Financial Instruments*, extends the use of fair value accounting for financial instruments.

This paper suggests that the Lisbon Treaty, which defines the goals of the European Union and the means it can use, should represent the framework within which financial reporting policies and their potential effects on the European socio-economic context are considered. The Lisbon Treaty states that the European Union shall work for a social market economy, aiming at full employment and social progress. Moreover, the European Union shall combat social exclusion, promoting social justice and protection. These are the fundamental principles that must inspire not only the actions undertaken by European policy-makers, but also academic research. According to Bertrand Russell (1919), science allows us to know the means to reach a goal, but it cannot suggest which goals must be reached. In general, financial reporting policies and, more specifically, fair value reporting should therefore be investigated in the European Union in terms of their capability to reach the goals stated by the Lisbon Treaty.

Along the same lines, this paper questions the legitimacy of the standards-setting process. The European Union has no say in how things are done, and it cannot even decide whether a given accounting issue should be examined. However, the Lisbon Treaty sets out the democratic principles on which the European Union is built. The European Union shall observe the principles of equality of its citizens, who shall receive equal attention from its institutions, and decisions shall be taken as openly as possible. The Lisbon Treaty also highlights the importance of social dialogue, which is key to the European social model.

Actually, the current private governance of the standards-setting bodies prevents some important stakeholders, such as manufacturing industry and labor representatives, from being part of the process. This paper therefore claims that the European Union should work to restore legitimacy to the standards-setting process, bringing it back to democratic rules that guarantee the representation of all the stakeholders involved in the economy. The success of the European Union in reinstating democracy in the standards-setting process is also crucial to the development of a more balanced governance of the world economy.

The discussion is organized as follows: Section 2 describes the IASB's approach to financial reporting, which is characterized by a move in the direction of a full fair value accounting system. Section 3 goes through the fair value definition as an exit price provided by IFRS 13, while Section 4 discusses the main controversial issues related to such a definition. Section 5 focuses on the politics of fair value reporting and discusses the main socio-economic consequences which it is supposed to bring in the European

Union. Section 6 analyses the governance of the standards-setting process, while Section 7 concludes.

2. THE IASB'S APPROACH TO FINANCIAL REPORTING: EXTENDING FAIR VALUE AS MUCH AS POSSIBLE

On January 2005, all listed companies in the European Union started using the International Financial Reporting Standards (IFRS) set out by the International Accounting Standard Board (IASB)³. IFRS were introduced in the European Union by the European Parliament and Council Regulation No. 1606, 19 July 2002, which mandates IFRS for consolidated financial statements of listed companies, with a member state option to apply IFRS to other reporting entities. A certain number of states - such as Italy, Belgium and Portugal - have extended IFRS to unlisted banks, insurance and supervised financial institutions, while others - such as Cyprus and Slovakia - require IFRS for all firms. Some other states - including Italy, Cyprus and Slovenia - have also extended IFRS to separate financial statements of certain types of firms.

Regulation 1606/2002 is very focused on capital markets. According to this regulation, adopting IFRS should ensure a high degree of transparency in financial statements and a high degree of comparability among financial statements of firms from different countries that previously used domestic GAAP based on the European Directives. This should in turn lead to a more effective and efficient functioning of the capital market. A higher level of transparency in financial reporting is in fact expected to lower the estimation risk premium which arises from information asymmetries and, as a result, reduce the firm's cost of capital. By enhancing comparability, IFRS adoption at European level should also reduce cross-country differences in the cost of capital and, therefore, foster competition for financial resources on an equal footing among firms.

The IASB's approach to financial reporting is consistent with the goals of Regulation 1606/2002. The IASB also focuses on equity investors, and fair value accounting is considered to be essential for tailoring financial reporting to their needs. Equity investors are considered to be those most in need of information from financial reports because they cannot usually request information directly from the firm. Moreover, as they provide risk capital to firms, the financial statements which meet their needs also meet most of the needs of other users (IASB 2010 BC 1.16).

³ For ease of exposition, the term IFRS is used to refer to both the International Accounting Standards (IAS) and to the International Financial Reporting Standards (IFRS). IFRS are issued by the IASB, whereas IAS were issued by the International Accounting Standard Committee (IASC), predecessor of the IASB until 2000.

Instead, the main concern of the fourth and seventh European Directives is the protection of debt-holders⁴. Prudence prevails over accrual and historical cost is the basic criterion for financial reporting. Historical cost accounting has however been criticized by many, mainly on the basis that it does not report commercial reality or provide an up-to-date valuation of net worth (Godfrey *et al.* 2010 for a review). As stated by the former chairman of the IASB Mr. Tweedie, “*the IASB and partner standard setters are tackling some of the fundamental challenges facing accounting today in order to make the accounting model relevant (...) Publicly traded companies are complex entities, engaged in a wide range of activities and subject to different market pressures and fluctuations. Accounting should reflect these fluctuations and risks. (...) The current direction we are taking will be what I like to call, “tell it like it is” accounting. This means an increasing reliance on fair values, when these values can be determined accurately*”. Indeed, fair value accounting is one of the most important innovations in financial reporting in the European Union, and it represents the main difference between IFRS and the European Directives. Fair value is supposed to provide investors with better information to predict the capacity of firms to generate cash flow from the existing resource base, thereby improving the quality of information for decision usefulness (e.g. Barth *et al.* 2001). Under fair value accounting, part of the information previously used exclusively for management control purposes is now given to the market. The concept of income changes from income produced to mixed income, which also includes potential profits. The concept of net worth is divested of its strictly juridical connotation and takes a more economic meaning, which makes a firm’s net worth converge toward its current market value.

Both the IASB and the FASB⁵ have made clear their view that fair value is likely to become the primary reporting basis for financial accounting in the future (Jordan *et al.* 2013). Among the most significant standards mandating fair value accounting are those that explicitly relate to financial instruments. In 2009 the IASB issued IFRS 9, *Financial Instruments*, which extends the use of fair value for financial instruments. In 2011, the IASB issued IFRS 13, *Fair Value Measurement*, which provides a single framework for measuring fair value and comprehensive evidence on “how” to measure fair value. IFRS 13 is the result of a joint project conducted by the IASB together with the FASB, with the specific purpose of harmonizing US GAAP and IFRS. In fact, IFRS 13 provides the same

⁴ Domestic GAAP based on the European Directives still apply to firms not adopting IFRS.

⁵ FASB stands for Financial Accounting Standards Board, the organization responsible for setting accounting standards for public companies in the United States (US).

definition of fair value as well as an alignment of measurement and disclosure requirements to FAS 157. IFRS 13 was endorsed in the European Union at the end of 2012 and, therefore, is already applied by firms using IFRS⁶.

3. FAIR VALUE AS AN EXIT PRICE

According to IFRS 13, fair value is an exit price. IFRS 13 defines fair value as the price that would be received to sell an asset in an orderly transaction between market participants at the measurement date. Therefore, fair value is a market-based, not an entity-specific measurement, and the firm's intention to hold an asset is completely irrelevant. For instance, the application of a blockage factor to a large position of identical financial assets is prohibited given that a decision to sell at a less advantageous price because an entire holding is sold, rather than each instrument individually, represents a firm-specific factor.

If observable market transactions or market information are not observable, the objective of fair value measurement still remains the same, that is to estimate an exit price for the asset, and the firm must use valuation techniques. Valuation techniques must be consistent with the market approach, income approach or cost approach. The market approach uses prices and other relevant information based on market transactions involving identical or comparable assets. The income approach uses valuation techniques to convert future amounts (e.g. cash flows or income and expenses) to a single present amount. Such valuation techniques include present value techniques, option pricing models and the multi-period excess earnings method. Finally, the cost approach reflects the current replacement cost, which is the amount that would currently be required to replace the service capacity of an asset.

Following FAS 157, IFRS 13 establishes a fair value hierarchy, which gives the highest priority to the use of quoted prices (Level 1 inputs) for fair value measurement and the lowest priority to unobservable inputs (Level 3 inputs). Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets that the firm can access at the measurement date. Quoted prices in active markets must be used whenever available. Level 2 inputs are inputs, other than quoted prices, that are observable - either directly or indirectly - for the asset. Level 2 inputs include, for instance, quoted prices for similar assets in active markets; quoted prices for identical or similar assets in markets that are not active; and inputs other than quoted prices that are observable for the asset, such as

⁶ In order to come into force in the European Union, IFRS must go through an endorsement process which involves many institutions. The endorsement process is examined in Section 6.

interest rates and yield curves, volatilities, prepayment speeds, loss severities, credit risks, and default rates. Level 2 inputs offer some discretion to management, although they are corroborated by observable market data. Adjustments to Level 2 inputs that are significant to the entire measurement result in a fair value measurement categorised within Level 3. Level 3 inputs are unobservable inputs for fair value measurement. Unobservable inputs are those for which market data are not available and, therefore, need to be developed on the best information in the markets and on the assumptions that market participants would make. Level 3 inputs offer considerable discretion to management and provide the highest degree of information asymmetry between preparers and users.

It is common to refer to mark-to-market accounting when fair values are based on Level 1 inputs and to mark-to-model accounting when fair value estimates are based on Level 2 and Level 3 inputs.

4. CRITICAL ISSUES IN FAIR VALUE REPORTING

The recent financial crisis has turned the spotlight on fair value accounting and has led to a major policy debate involving, among others, the US Congress and the European Commission as well as banking and accounting regulators around the world. Critics argue that fair value accounting has significantly contributed to the financial crisis and exacerbated its severity for financial institutions all around the world. Opponents claim that fair value is not relevant and is potentially misleading for assets that are held for a long period and, in particular, to maturity; that prices could be distorted by market inefficiencies, investor irrationality or liquidity problems; that fair values based on models are not reliable; and that fair value accounting contributes to the procyclicality of the financial system (e.g. Benston 2008 and Ryan 2008). At the other extreme, proponents of fair value accounting have argued that it merely played the role of the proverbial messenger now being shot. Many have in fact argued that fair values for assets or liabilities reflect current market conditions, providing timely information and thereby increasing transparency and encouraging prompt corrective action (e.g. Turner 2008 and Veron 2008).

A few dispute the importance of transparency, but the controversy rests on whether fair value accounting is indeed helpful in providing transparency or whether it leads to undesirable actions on the part of banks and firms. In particular, fair value accounting has raised two main concerns. The first relates to procyclicality and contagion effects that fair value accounting is supposed to cause by increasing volatility in financial markets.

The second is about the reliability of fair value estimates based on valuation techniques, which are especially problematic when active markets do not exist, as was the case for the interbank market during the financial crisis in 2007-2008. The recent financial crisis has made these two concerns a particularly pressing issue.

4.1. Fair value as a vector of crisis

Fair value defined as an exit price has been subject to considerable debate especially for its procyclical effects on real economy (e.g. European Central Bank 2004, Banque de France 2008, International Monetary Fund 2008). Allegedly, during the recent financial market crisis fair value accounting exacerbated swings in the financial system and caused a downward spiral in financial markets, which have made the crisis more severe, amplifying the credit-crunch (e.g. Plantin *et al.* 2008 Persaud 2008).

According to the former Chairman of the Federal Deposit Insurance Corporation (FDIC), William Isaac (2010), fair value accounting regulation is the primary cause of the financial crisis. As a matter of fact, in 2007 significant signs of weakness in the real estate market began to emerge in the US and non-payment of mortgages led to a sharp increase in foreclosures. This in turn led to a downgrading of exotic financial instruments, such as securitized mortgages in the form of collateralized mortgage obligations (CMOs), which affected their prices negatively. The financial crisis was further aggravated by the derivative markets, which were hit particularly hard by defaults in the underlying mortgage assets. As a result of mark-to-market regulation, the asset values of financial institutions – especially those of mortgage-backed securities - declined significantly. In such a distressed market, it was difficult to sell these securities, and the lack of demand in return resulted in more drastic reductions in their market value. The fear of a contagion effect induced banks to get rid of these securities, which depressed prices further and forced write-downs. Banks therefore started accumulating huge losses, which significantly impaired their capability to lend money, and provoked a domino effect (Jaggi *et al.* 2010).

Allen and Carletti (2008) and Plantin *et al.* (2008) provide useful insights into the role of fair value accounting in the recent financial crisis by modelling its potential contagion effects. Allen and Carletti show that due to mark-to-market accounting, the balance sheets of financial institutions are driven by short-term market fluctuations that do not reflect their fundamentals. When liquidity plays an important role, as in financial crises, asset prices reflect the amount of liquidity available rather than the asset's future cash-flows. Bank assets may therefore fall below their liabilities so they become insolvent, despite the capability of the banks to fully cover their commitments if allowed to continue

until the assets mature. Instead, if financial reporting is based on historical cost, temporarily illiquid financial markets do not affect asset value, and banks can continue to meet their future liabilities. Allen and Carletti therefore conclude that in the case of illiquid markets other methods for pricing the assets, such as historical cost, are preferable to fair value accounting.

Likewise, Plantin *et al.* (2008) show that mark-to-market accounting injects an artificial volatility which is purely a consequence of the accounting norms, rather than something that reflects the underlying fundamentals. Real decisions would then be distorted as a consequence of the measurement regime. Their analysis also suggests that damage done by mark-to-market accounting is particularly severe for assets that are long-lived, illiquid and senior, which are precisely the attributes of the key balance sheet items of banks and insurance companies. These results are also consistent with Cifuentes *et al.* (2005), Khan (2009) and Bowen *et al.* (2010).

Novoa *et al.* (2009) show that sale decisions in distressed markets with already falling prices activate margin calls and sale triggers that are a component of risk management, thus contributing further to the downward trend. As bank net worth is positively correlated with the business cycle, and fair value market values for collateral values fall, losses have been passed through to bank capital (Kashyap 2005). Along the same lines, Ronen (2012) notes that because many contracts require cash collateral payments when one of the parties' debts are downgraded, the downgrades trigger cash collateral demands and increase strain on the liquidity of the downgraded institution. In addition, the downgrades may trigger demands by regulators for the infusion of additional equity capital precisely at the point in time when markets are illiquid and the cost of capital is unusually high. This can open the march into solvency of institutions that would otherwise be solvent. At this point, the insolvency or near insolvency of the institutions that are forced to write down their assets gives rise to write-downs in connected institutions, with relevant contagion effects.

During the crisis, the weakening of bank balance sheets and regulatory requirements for prudential capital replenishment heightened concerns over the future course of some markets, the health of banks and, more broadly, of the financial system, as well as the aftermath of the financial crisis on the real economy. In the summer of 2007 holders of short-term liabilities refused to fund banks, expecting losses on subprime and subprime-related securities (Gorton 2008). Moreover, there were several runs on banks (Allen *et al.* 2009b).

Since banks play a crucial role in the economy as a whole, financial distress in the banking system has relevant consequences on real economy and employment. Freixas and Tsomocos (2004) show that mark-to-market accounting worsens the role of banks as institutions smoothing inter-temporal shocks. Dell’Ariccia *et al.* (2008) provide evidence of the correlation between bank distress and decline in credit and in GDP. Indeed, due to the financial system crisis in 2007-2009, economic activity has declined significantly in the US and in the European Union and unemployment has risen dramatically. There is consensus that this is the worst crisis since the Great Depression (Allen *et al.* 2009b).

4.2. Fair value reliability under mark-to-model accounting

Laux and Leuz (2009) suggest that a way to tackle the procyclicality of fair value accounting and its contagion effects is to deviate from market prices in situations when contagion is likely to occur.

Both IFRS 13 and FAS 157 allow such deviations in certain circumstances. These standards state in fact that market prices from forced sales should not be used, which protects against negative spillovers from distressed banks. When market become inactive, valuation models must be used to derive fair value so as to mitigate contagion effects.

As a matter of fact, as the illiquidity of certain products became more severe during the financial crisis started in 2007, financial institutions turned increasingly to model-based valuations, and Level 2 and 3 assets represented a great amount on the balance sheets of large bank holdings and investment banks (Laux and Leuz 2010). If mark-to-model accounting was expected to reduce procyclicality and financial market volatility, it was nevertheless accompanied by growing opacity in the classification of products across the fair value spectrum. Moreover, the wide use of unobservable inputs in stressed liquidity conditions increased uncertainty among financial institutions, supervisors and investors regarding the valuation of financial products (Novoa *et al.* 2009).

Critics argue that fair value based on valuation techniques is less verifiable by investors, subject to greater estimation errors by management and prone to greater managerial manipulation. These shortcomings create information asymmetry between investors and managers and can be a serious threat to financial reporting reliability. For this reason, Warren Buffet (2003) has defined mark-to-model accounting as “*a large scale mischief*”. By introducing estimation errors, valuation techniques produce artificial volatility in financial reporting (Watts 2003a; Watts 2003b; Landsman 2007; Penman 2007). Barth (2004) shows that volatility from period-to-period in fair values and, it follows, in

financial statements derives from two sources. One is the firm's activity during the period and changes in economic conditions. This volatility, called inherent volatility, derives from economic, not accounting forces. Inherent volatility is the volatility of the asset itself. However, there is another source of volatility, namely estimation error volatility, which is related to the fact that accountants do not usually observe the fair value of an asset and therefore need to estimate it. As a result, fair values obtained by valuation techniques entail estimation errors, and the resulting asset volatility is attributable not only to inherent changes in economic conditions, but also to measurement errors. Since volatility is expected to become greater as fair value inputs become less observable, the reliability of Level 2 and Level 3 inputs to fair value measurement is a critical issue for standards-setting purposes.

Consistent with the IASB'S approach to financial reporting, research has long investigated the reliability of fair value estimates from an equity investor's perspective. As outlined by Barth *et al.* (2001), share prices reflect accounting numbers to a different degree according to the amount of information relevant to investors in valuing a firm. This, in turn, happens if the information is measured reliably enough to be reflected in share prices. If fair value accounting is unreliable, or investors do not understand the degree of imprecision, then reported values would not be value-relevant to security prices.

Overall, research suggests that fair value relevance for financial instruments varies according to the source of information (e.g. Petroni and Wahlen 1995, Nelson 1996, Eccher *et al.* 1996). Investors are aware of estimation errors and therefore value the three fair value levels differently. Kolev (2009), for instance, shows that investors place less weight on less reliable fair-value measurements. Goh *et al.* (2009) observe significant variation in the pricing of different levels of fair value assets, with the pricing being lower for mark-to-model assets, i.e. assets with lower liquidity and greater information risk, than for mark-to-market assets. Likewise, Song *et al.* (2010) provide evidence that Level 3 fair value measurements are valued less than Level 1 and Level 2 assets. Finally, Fiechter and Novotny-Farkas (2011) show that the value relevance of fair value assets decreased as the financial crisis worsened, which suggests increased uncertainty about the reliability of financial data.

A certain number of studies have focused on private equity valuation, showing that using data relative to publicly traded companies could be highly misleading. Quigley and Woodward (2002) and Moskowitz and Vissing-Jorgensen (2002), for instance, report lower returns for private than for public equity. Cochrane (2005) documents an

extraordinary skewedness of returns, as most are modest, with a long tail of extraordinary good returns. Kim and Ritter (1999) show that the predictive ability of market multiples for private equity valuation is poor and relevant adjustments for differences in growth and profitability are necessary, given the wide variation of such ratios within an industry. Finally, Maino and Palea (2013) document that transaction and market multiples tend to overestimate exit values. Transaction multiples are cases of 'revealed preferences', i.e. they refer only to successful transactions and incorporate synergy expectations as well as other positive factors which increase transaction prices. Market multiples, instead, tend to elide the idiosyncratic component of risk. Transaction and market multiples also lead to highly volatile fair values, which are largely affected by the economic cycle as well as by market trends, with important effects on fair value measurement. Maino and Palea therefore question whether IFRS 13 is compliant with European Union Regulation 1606/2002, whose main purpose is to ensure a high degree of transparency and comparability in financial information, and the IASB Framework, which states that financial reporting shall provide investors with a faithful representation of the real-world economic phenomena they purport to represent.

Much of the research on the relevance and reliability of valuation techniques has focused on financial assets and liabilities, to which fair value reporting largely applies. However, several studies have also investigated this issue with regard to non-financial assets, producing results in line with findings relative to financial instruments (e.g. Easton *et al.* 1993, Cotter and Richardson 2002, Muller and Riedl 2002).

4.3. Stewardship and the role of strategic intent in defining asset value

As mentioned, IFRS 13 states that fair value is a market-based measurement, which reflects the amount that would be received when selling an asset in an orderly transaction between market participants at the measurement date. Fair value is therefore a spot market price.

The definition of fair value as an exit value has raised a number of concerns even among many of those who support fair value accounting, as it does completely ignore the value of the employment of the assets within the firm (e.g. Whittington 2008). Allen and Carletti (2008), for instance, show that during financial crises asset prices reflect the amount of liquidity available, rather than future payoffs from the actual asset, i.e. the asset value in use.

Benston (2008) argues that fair value expressed as an exit value is useful primarily to creditors and shareholders of companies that face likely liquidation. For stockholders of and potential investors in going concerns, though, the relevant asset values for

investment decisions are values in use, that is, the present value of the net cash flows which the assets are expected to generate within the firm. Exit values are clearly not relevant to these parties, except in those instances where the assets are to be sold soon. Ryan (2008) highlights that market-based fair values misrepresent management intent to hold an asset, while Koonce *et al.* (2011) document that investors are aware of this and are in fact reluctant to embrace fair values for items not to be sold soon.

By giving a seemingly relevant liquidation value at each point, exit price accounting obscures the value creation process by mixing present profit with capital gains and losses, which will probably never be realized. As Boyer (2007) points out, exit price accounting paradoxically exchanges supposed low information quality provided by historical cost for a less accurate assessment of the valuation of the firm were it to be liquidated today, a rather unlikely event. As a result, many academics have claimed that the definition of fair value as an exit price falls short of meeting the informational objective of financial statements (e.g. Benston 2008; Whittington 2008; Ronen 2012). Exit value does not reflect the value of the employment of assets within the firm, and does not inform investors about future cash flows the assets may generate, the present value of which is the actual fair value to shareholders.

Exit value does not even serve a stewardship function, as it does not properly measure managers' ability to create value for shareholders (e.g. Ronen 2012). Under exit value accounting, the management's own private information about future cash flows and company risks is ignored, which conflicts with the primary role of accounting to convey useful information possessed by the management alone to external, otherwise uninformed, investors. Fair value should therefore reflect the opportunities related to the investment actually available to the reporting entity, for which entity-specific assumptions are necessary. As a result, value in use requires including future cash flows expected by the entity, which could not be expected from other market participants.

While value in use holds for a long-term approach, a definition of fair value as an exit price concentrates on a short-term approach to valuation. These two different approaches to fair value accounting correspond to two different perspectives on the purpose of financial accounting, which in turn are based on two broad schools of thought. Fair value accounting defined as an exit price emphasizes the role of financial reporting in serving investors in capital markets; relevance is the primary characteristic required in financial statements, whereas reliability is less important; accounting information needs to reflect the future, not the past, so past transactions and events are only peripherally relevant; markets are generally sufficiently complete and efficient to provide

evidence for representationally faithful measurement (Whittington 2008). The IASB along with the FASB adopt this approach to financial reporting.

Instead, a definition of fair value as value in use claims that stewardship, defined as accountability to present stakeholders, is a distinct objective, ranking equally with decision usefulness; present stakeholders of the holding company have a special status as users of financial statements; future cash flows may be endogenous; financial reporting relieves information asymmetry in an uncertain world, so reliability is an essential characteristic; past transactions and events are important both for stewardship and as inputs for the prediction of future cash flows (as indirect rather than direct measurement); the economic environment is one of imperfect and incomplete markets in which market opportunities are entity-specific (Whittington 2008). The implications of this perspective are that the information needs of present stakeholders, including stewardship requirements, must be met; past transactions and events are considered to be relevant information and, together with the reliability of measurements and the probability of existence, critical requirements for the recognition of elements of accounts in order to achieve reliability; prudence can enhance reliability; cost (historical or current) can be a relevant measurement basis, for example as an input for the prediction of future cash flows, as well as for stewardship purposes; financial statements should reflect the financial performance and position of a specific entity, and entity specific assumptions should be made when these reflect the real opportunities available to the entity; performance statements and earnings measures can be more important than balance sheets in some circumstances.

Although this perspective serves investors, it does however give priority to existing stakeholders and regards stewardship as an important and distinct function of financial reporting. It also seeks accounting information that is relevant to forecasting future cash flows, but it assumes that this will often be achieved by providing information useful as an input to valuation models, rather than a direct valuation of future cash flows. Moreover, in order to be useful, such information must be entity specific. This view is supported by the Financial Stability Board (2010), who state that “*while reaffirming the framework of fair value accounting, we have agreed that the accounting standards setters should improve standards for the valuation of financial instruments based on their liquidity and investors’ holding horizons*”.

5. THE POLITICS OF FAIR VALUE REPORTING

The former sections highlight many of the concerns which have made fair value accounting so controversial. Both theoretical and empirical research raises relevant issues regarding the definition of fair value as an exit price and the reliability of market-based valuation techniques. Many have questioned the procyclical effects of mark-to-market accounting, while others have argued that mark-to-model accounting entails estimation errors, which bear significant economic consequences. As a rule, fair value measurement based on valuation techniques leads to less reliable information, higher expected returns for investors, and lower ability to monitor managerial behavior. Some others have instead claimed that the definition of fair value as an exit price does not suit assets that are held with strategic intent, with no expectation of short-term capital gains. A market-based, rather than entity-specific, fair value measurement fails to consider the investor's horizon, which is key to asset valuation.

If this is the case, why, and how, has such a controversial accounting method gained so much support?

In the last 40 years, the economies of the world have undergone profound transformations: the role of government has diminished, while that of the markets has increased; economic transactions between countries have risen substantially; domestic and international financial transactions have grown by leaps and bounds. In short, this changing landscape has been characterized by the rise of neoliberalism, globalization, and financialization (Epstein 2005). The financialization of the economy has involved the increasing role of financial motives, financial markets, financial actors and financial institutions in the operation of the domestic and international economies (Epstein 2005).

Accordingly, shareholder value has become a central feature of the corporate governance ideology, which has spread across the whole private-sector (Froud *et al.* 2000, Lazonick and O'Sullivan, 2000). For manufacturing corporations, the power of finance increased at the expense of production. Under the pressure of financial markets for more income and more rapidly growing stock prices, non-financial corporations started moving into financial operations to increase profits, which made profits from financial activities rise sharply relative to those made directly from production (Dumenil and Lévy 2005, Crotty 2005, Epstein 2005, Krippner 2005, Nölke and Perry 2007, Boyer 2007). Moreover, non-financial corporations started paying increasing dividends to shareholders, while also repurchasing their own equity to maintain rising share prices. These dividends and stock-repurchases, however, did not stem from underlying earnings, but were debt-

funded. The net effect was an ongoing transfer from the non-financial to the financial sector, much of which was through interest payments (Dumenil and Lévy 2001).

Fair value accounting, and in particular its definition as an exit price, underlines and deepens the impact of the shareholder value paradigm in corporate governance, shifting power from managers to markets. The definition of fair value as an exit price reduces the enterprise's voice in favour of that of the market, and the reporting of assets, liabilities and income becomes independent of the manager's influence (Barlev and Haddad 2003). When analysing financial statements, readers are therefore sensitive to the "market's voice".

Furthermore, fair value as an exit price leads both enterprise managers and investors to consider the firm as a portfolio of assets that must constantly be reconfigured and rationalised in order to maximise shareholder value. Fair value accounting pushes managers to demand that every corporate asset is put to its most profitable use as judged by market benchmarks. Since capital markets tend to take a more short-term perspective on profit, fair value accounting therefore discourages more long-term industrial strategies (Nölke and Perry 2007). Botzem (2012) also notes that fair value as an exit price requires that efficiency is defined purely in monetary terms as opposed to industrial terms, and exclusively from the perspective of the financial sector. As a result, the company becomes a bundle of capital flows that obscure the company's internal value-creation process.

Perry and Nölke (2006) maintain that those who profit from, and at the same time perpetuate, the shareholder value ideology, are not however the shareholders, but investment funds, their fund managers, and analysts. Owners of shares do not – for the most part – actively participate in trading, but delegate this task to investment funds, pension funds, insurance companies and investment banks. Similarly, market-based asset prices do not represent some sort of abstract social equilibrium, but the actions of traders, which in turn reflect the views of dominant market analysts and pundits who do not necessarily make long-term calculations oriented to broader societal interests. As a result, enterprise managers lose further power, and most of the principals in the financial system – i.e. savers, pensioners and future pensioners - are not in the picture.

As mentioned above, accounting is not simply a metric; rather, it is embedded in an institutional context, and shapes social and economic processes (Miller and O'Leary 1987). In the case of today's advanced industrialized economies, the socio-economic context may be characterized in terms of "Anglo-Saxon" or "Rhenish" varieties of

capitalism⁷. The defining characteristics of the Rhenish model typical of Germany and the Scandinavian Countries are the consensual (for the most part) relationship between labour and capital, the supporting role of the state, and the availability of patient capital provided by the bank system or internally generated funds. These characteristics are compatible with a long-term perspective of economic decision-making, which evidence has shown to be crucial for high skilled labour and quality products based on incremental innovation (Hall and Soskice 2001).

As Denis and McConnell (2003) note, in many European Countries shareholder wealth maximization has never been the only – or even necessarily the primary – goal of the board of directors. In Germany, for instance, firms are legally required to pursue the interest of parties beyond the shareholders through a system of co-determination in which employees and shareholders in large corporations sit together on the supervisory board of the company (Rieckers and Spindler 2004, Schmidt 2004). Austria, Denmark, Sweden, France, and Luxembourg also have systems of governance which require some kind of co-determination (Wymeersch 1998, Ginglinger *et al.* 2009). While the specific systems of governance in each of these countries vary widely, the inclusion of parties beyond shareholders is a common concern. As a result, workers play a prominent role and are regarded as important stakeholders in the firm. Moreover, not only do the legal systems in these countries require firms to take stakeholder concerns into account, but also social convention. Yoshimory (1995) shows, for instance, that an overwhelming majority of managers in France and Germany feel that a company exists for the interest of all stakeholders, whereas shareholder interest is the priority for managers in the US and the UK.

Allen *et al.* (2009a) have highlighted the advantages and disadvantages of stakeholder-oriented firms as opposed to shareholder-oriented firms, showing that stakeholder orientation can be beneficial for company value. Their results are consistent with Hillman and Keim (2001) and Claessens and Ueda (2008), who find that greater stakeholder involvement in the form of stakeholder management or employment protection improves efficiency and firm value. Likewise, Fauver and Fuerst (2006) and Ginglinger *et al.* (2009) find that employee representation on the board increases firm value as measured by Tobin's Q and profitability. In addition, stakeholder governance may reduce the probability of failure, which increases debt capacity and consolidates a

⁷ The “Anglo-Saxon” model refers to liberal market economics, whereas the “Rhenish” model refers to coordinated market economics (Hall and Soskice, 2001). These two models have been developed on the basis of US and western Europe. For other capitalist economies, further models are of course necessary (Nölke and Vliegthart, 2006).

close relationship between banks and firms such as, for instance, in the *hausbank* system in Germany (Allen *et al.* 2009a). Indeed, the European financial system, especially in continental Europe, is highly bank-oriented compared to the Anglo-Saxon countries⁸. The industrial structure is also different: while services run by big companies are relevant in the Anglo-Saxon countries, manufacturing industries run by small-and medium-size firms are the backbone of the economy in the continental European Union.

As mentioned, accounting rules based on the European Directives applied to all firms in the European Union up to 2005. Such rules are rather conservative and prudent, thus leading to understated book values of assets and overstated liabilities. Such conservative accounting standards evolved in an environment where banks were primarily concerned with ensuring the securities of their long-term loans to enterprises, and so took a relatively cautious view of the future, acknowledging its inherent uncertainty. A prudent valuation of separable assets served to reassure both bankers that there was sufficient collateral to support their loans and employees that the firm was solvent and stable over time.

There is wide consensus that the rather conservative accounting standards based on the European Directives, combined with Rhenish corporate governance and corporate financing arrangements, have allowed companies to follow long-term strategies, such as investing heavily in human resource development. This has been crucial for maintaining the Rhenish competitive advantage of using highly skilled labour to produce high quality, and often specialized, products (Sally 1995, Froud *et al.* 2000, Lazonick and O'Sullivan 2000, Perry and Nölke 2006).

Fair value accounting, instead, has been developed within the Anglo-Saxon variety of capitalism, which is characterized by more adversarial management-labour relations, comparatively short-term employment, the predominance of financial markets for capital provision, an active market for corporate control, and an increased emphasis on short-term price movement on stock markets. Capital providers are usually outsiders to the firm, thus publicly available information is crucial to them (Hall and Soskice 2001). The definition of fair value as an exit price institutionalises the financialization of the economy in the form of accounting practise, increasing pressure from short-termism, i.e. from the shareholders' focus on quarterly results and short-range returns on investment (Sally 1995). As noted by Perry and Nölke (2006), short-termism is likely to exert disruptive effects on the Rhenish variety of capitalism, where more long-term strategies

⁸ In 2012 bank debts represented 31.4% of liabilities in the euro-zone, in contrast to 14.2% in the United States (Bank of Italy 2013).

and investments have been key for maintaining competitive advantage. Quantitative studies have also shown that an excessive focus on shareholder value can reduce the rate of capital accumulation over the long term (Stockhammer 2004). Furthermore, short-termism is likely to lead to more conflictual relationships between enterprise managers, employees and other stakeholders, especially in those states in the continental European Union where companies have grown on more consensual corporate governance arrangements. As a result, the shift to fair value reporting put firms in a social market economy at a competitive disadvantage, with the risk of the Rhenish variety of capitalism being altered irrecoverably.

6. GOVERNANCE OF THE STANDARDS-SETTING PROCESS

Considering the potential disruptive effects of fair value accounting as an exit price on the socio-economic system, a question naturally arises: how has fair value accounting been able to gain such authority so quickly? Why did those social constituencies that lost power from the shift to fair value accounting have no way of making their voices heard during the standards-setting process? Are all social groups impacted – albeit indirectly – by the accounting regulation represented in the standards-setting process?

While accounting standards in the European Union were previously set at a national level by a combination of public and private actors within the context of the European Directives laid out by the European Parliament, the standards-setting process is now managed by the IASB.

The IASB's case is one of the most fascinating cases of private authority in international affairs (Sinclair 1994, Cutler *et al.* 1999, Hall and Biersteker 2002). The IASB is in fact a private, independent, British law organisation, controlled by the IFRS foundation. The foundation is a non-profit private-sector organization registered in the US state of Delaware, which is financed by large industrial and service companies, auditing firms and international as well as public organizations (IFRS Foundation 2013).

By adopting IFRS, the European Union – which is the second largest capital market in the world – has contributed towards creating a new space at an international level where financial accounting practices and their influence on socio-economic processes are exposed to the decision-making of a private body. This is a substantive issue, given that the changes taking place in the standards themselves are not just a matter of a few minor discrepancies between the former standards and the IFRS; they are rather a Copernican revolution in financial reporting.

The IASB is organized according to the “indirect-rule” tradition for standards-setting, which delegates the authority to design standards to a professional body of accountants. The IASB is composed of sixteen accounting experts appointed by a group of trustees based on their professional accomplishments and experience in the accounting sector. This approach should ensure that standards are designed using due process in an apolitical and neutral setting. Delegating authority to accountants should help maintain the accounting community’s historical role as a neutral arbiter between investors and managers without political interference (Veron *et al.* 2006). The trustees are in turn appointed by a monitoring board composed of public officials from the International Organization of Securities Commissions (IOSCO), the European Commission, the Financial Services Agency of Japan, and the US Securities and Exchange Commission (SEC). This should emphasize the value of the independence of the IASB members and ensure that the IASB is composed of standard-setters who are free from any commercial and political interests and have demonstrated expertise in addressing the informational needs of capital markets (Turner 1999).

According to Gramsci’s notion of organic intellectuals (1971), expert knowledge is however always political because it is acquired in a particular social context, and reflects the political-economic structure and social relations which generate and reproduce that context. If one considers the IASB Board, its composition is largely limited to members from the financial industry as well as from big auditing firms (IASB 2013). In this respect, the IASB is strongly affected by the structural power of the private financial sector, which can use the IASB as a vehicle for institutionalizing its own perspective on what value is, and how to measure it, within international financial reporting standards (Thistlethwaite 2011). Other types of actors, instead, including companies from the manufacturing sector, domestic regulatory agencies, labour unions, are not in the picture. For this reason, many have raised several concerns about the IASB’s composition and independence (e.g. Simmons 2001, Drezner 2007).

Research has also documented a tight link between the financial background of standard setters and the proposal of extending fair value accounting (Ramanna 2012). Different reasons can be outlined for such strong support for fair value. The first and most naïve is that investment banks and asset managers are accustomed to using fair value in risk management, which has shaped their preferences in public financial reporting standards. The second, less naïve, is that fair value accounting accelerates the recognition of gains: to the extent that managerial bonuses are based on profit numbers, financial service executives reap richer reward in a fair value regime. The third is that the use of

fair value to determine the impairment of goodwill from merger and acquisition activity, instead of the historical cost approach of amortising goodwill, imposes less systematic drag on earnings, thus potentially boosting merger and acquisition activity, which is a major source of revenue for investment banks (Ramanna 2012).

The composition of the IASB also reveals a dominance of representatives of the Anglo-Saxon countries and of international organizations whose priorities conform to Anglo-Saxon preferences (IASB 2013). Many have in fact highlighted the pivotal role played by the SEC, operating through the IOSCO, *“who have pushed for accounting practices that are broadly aligned with Anglo-American hegemony”* (Crawford *et al.* 2013; see also Arnold 2005, Martinez-Diaz 2005, Nölke and Perry 2007, Botzem 2008, Botzem and Quack 2009, Noël *et al.* 2010). IFRS 13, which is virtually identical to its US counterpart SFAS 157, actually exemplifies how a US discourse pervades the IASB and the accounting standards-setting agenda. This is a key issue, considered the potential economic and distributional consequences produced by financial reporting (Martinez-Diaz 2005).

In order to come into force in the European Union, the IFRS must go through an endorsement process. According to Regulation 1606/2002, IFRS can be adopted in the European Union only if they conform with the “true and fair view” that is dominant in the European Directives; if they are conducive to the European public good, which is not however elaborated on; if they meet the criteria of understandability, relevance, reliability, and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management.

The endorsement process consists in several steps and involves many institutions. One of these is the European Financial Reporting Group (EFRAG), which is a technical expert committee that provides advice to the European Union on whether a new standard meets the criteria of endorsement. Moreover, even if it is not required to report on this, EFRAG delivers its advice on whether the new standard is conducive to the European public good and, therefore, if it is of overall interest to the European Union. The other institution involved in the endorsement process is the Accounting Regulatory Committee (ARC), which is composed of representatives from the European Union member states. If EFRAG’s advice is favourable to the standard, the Commission prepares a draft endorsement Regulation which is voted by the ARC. If the ARC’s vote is also favourable, which has been the case for almost all standards to be endorsed, once 3 months have elapsed without opposition from the European Parliament and the Council of the European Union, the European Commission adopts the new IFRS. IFRS 13, for instance, was endorsed by the European Union at the end of 2012 on the basis of positive advice

from EFRAG, which stated that “*IFRS 13 is not contrary to the principle of “true and fair view”(…) and meets the criteria of understandability, relevance, reliability and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management. For the reasons given above, EFRAG is not aware of any reason to believe that it is not conducive to the European public good to adopt IFRS 13 and, accordingly, EFRAG recommends its adoption*”.

Like the IASB, EFRAG is a privately held and managed organization, funded by its members. EFRAG is operated in a very similar way to the IASB, with a two-tier structure and the same distribution of roles. The members of its supervisory Board (equivalent to the IFRS Foundation’s Trustees) are appointed by the organisations that founded, and finance, EFRAG. Its Technical Expert Group (TEG) – the equivalent to the IASB’s Board – has 12 voting members, selected from a range of professional and geographical backgrounds from throughout Europe. However, the Technical Expert Group is predominately represented by the financial sector and big auditing firms⁹.

In conclusion, the European Union’s move to assert itself in the battle for global accounting standards has actually led to a dismantling of accounting regulation under the control of the European Parliament in favour of practices developed and endorsed by private institutions with an over-representation of financial market organizations, financial institutions and big auditing firms.

7. CONCLUDING REMARKS: EXAMINING FINANCIAL REPORTING POLICIES IN THE FRAMEWORK OF THE LISBON TREATY

Proudhon (1846) used to say that “*the accountant is the true economist*”. Indeed, financial reporting affects a great variety of constituencies: not only market actors, such as firms, investors, bankers and auditors, but also simple citizens, employees, and states, as financial information serves as a basis for determining a number of economic rights. Considering accounting standards independently of the socio-economic context is therefore inadequate.

This paper provides a general framework that deals with the potential changes in society induced by financial reporting. It highlights how accounting practises are embedded in an institutional context and therefore have the very potential to modify the socio-economic environment.

⁹ For insight into EFRAG governance and its networking with IASB, see Perry and Nölke 2006, Noël *et al.* 2010, Chiapello and Medjad 2009, Crawford 2013.

More specifically, this paper focuses on fair value accounting, showing how it is integral to the financialisation of the economy. Fair value defined as an exit price is an effect of an increasing focus on financial markets, which at the same time reinforces this trend, with potential disruptive effects on social market economies (e.g. Nölke and Perry 2007). Shareholders' value maximization does not necessarily correspond to more long-term strategies, which have been key for some countries in the European Union to develop and maintain their competitive advantage. Moreover, the shareholders' value paradigm is likely to modify the relationship between managers, financiers and wage earners and, in the end, the socio-economic context typical of the Rhenish variety of capitalism (e.g. Botzem 2012).

Delegating the standards-setting process to the IASB has greatly contributed to this shift to fair value accounting (Botzem and Quack 2009, Nölke *et al.* 2010, Bengtsson 2011, Crawford *et al.* 2013). The IASB is largely influenced by, but also empowers, the private financial sector in governing how accounting standards measure value. Many critics have therefore raised concerns over the IASB's independence from dominant global financial powers (Simmons 2001, Perry and Nölke 2006, Drezner 2007, Thistlethwaite 2011, Botzem 2012). The same holds for EFRAG, which suffers from a lack of representation of some important stakeholders involved in the European Union economy, such as employees and managers from the manufacturing industry.

This paper concludes with some questions and proposals for future debate. Pragmatically, its purpose is not to provide definite solutions, but to make a ground-clearing exercise designed to set a framework which can be used to reorient the politics of accounting regulation, and to convince scholars of the importance of this issue. As mentioned above, accounting is not simply a metric; it is rather a calculative practice, which shapes the socio-economic context. Therefore, it is important to discuss financial reporting policies within a broader view.

Financial Reporting is one of the competences of the European Union, which must legislate and adopt binding acts necessary to pursue its goals in this field. The goals of the European Union are set out by the Lisbon Treaty¹⁰, which states, in art. 2, that the European Union “*shall work for the sustainable development of Europe based on*

¹⁰ The Lisbon Treaty defines the principles that found the European Union. The Lisbon Treaty is an international agreement which amends the two Treaties that form the constitutional basis of the European Union, i.e. the Maastricht Treaty - also known as the Treaty on European Union - and the Rome Treaty establishing the European Community. The Lisbon Treaty was signed by the European Union member states on 13 December 2007, and entered into force on 1 December 2009. According to its Preamble, the aim of the Treaty is to enhance the democratic legitimacy of the Union and to improve the coherence of its action. The Lisbon Treaty has altered the structure of the European Union and institutions, and how they work, accordingly.

balanced economic growth and price stability, a highly competitive social market economy, aiming at full employment and social progress [...] it shall combat social exclusion and discrimination, and shall promote social justice and protection". These are the principles on which the European Union has decided to build and shape its future. The concept of "social market economy", for instance, dictates that the European Union shall act and intervene whenever the market provides negative outcomes for society.

Consistent with this view, this paper claims that IFRS in general, and fair value accounting as an exit price more specifically, must be discussed in the light of art. 2 of the Lisbon Treaty. The politics of fair value accounting, as well as the governance of the standards-setting process, should therefore be considered in terms of their capability to match with, and to promote, a sustainable social market economy. Is an extensive use of fair value accounting likely to guarantee balanced economic growth? Isn't financial stability, which evidence shows to be threatened by fair value accounting, perhaps part of these values? Does the current governance of the standards-setting process promote social inclusion, social justice and protection? Also, academic research should investigate financial reporting issues in terms of their capability to pursue the fundamental principles of the European Union stated by the Lisbon Treaty. According to Bertrand Russell (1919), science in fact allows us to know the means to reach a goal, but it cannot suggest which goals must be reached.

Furthermore, art. 8 of the Lisbon Treaty sets out the democratic principles on which the European Union is built. The European Union shall observe the principle of equality of its citizens, who shall receive equal attention from its institutions, bodies, offices and agencies. The functioning of the Union shall be founded on representative democracy, and decisions shall be taken as openly and as closely as possible to the citizen. Finally, the Lisbon Treaty highlights the importance of social dialogue, another important pillar of the European social model¹¹.

Indeed, social dialogue has turned out to be an asset and has proved its value in the recent years of crisis. It is not just a coincidence that the best performing member states in terms of economic growth and job creation, like Germany or Sweden, enjoy strong and institutionalised social dialogue between businesses and trade unions. So, is the current governance of the standards-setting process transparent and coherent to these ideals? Are the rights of all the stakeholders considered in the process?

¹¹ See art. 136 A of the Lisbon Treaty.

As discussed above, the standards-setting process shows a deficit of legitimacy. The structural power exercised by the specific make-up of the IASB has direct repercussions for the ability of different social constituencies to take part in the standards-setting process. The choice of transnational private governance in place of public regulation makes it in fact impossible for some stakeholders to influence the outcome of the standards-setting process.

The current situation provides evidence of the European Union's lack of power in the international standards-setting arena. The European Union have no say in how things are done, and cannot even decide whether and when a given accounting issue should be examined. Since accounting does not serve only to inform investors, but is also used to set the limit for distributable profits, to elaborate public budgets and, of course, for tax purposes¹², there are several concerns raised by the member states which are not covered by the work of the IASB (Chiapello and Medjad 2009).

Given the potentially highly destabilizing effects of financial reporting on society, this paper claims that it is necessary for the European Union to restore the legitimacy of the standards-setting process, bringing it back to democratic rules that guarantee the representation of all the stakeholders involved in the economy. In fact, there is a need to reorient the dominant paradigm of private self-regulation and fix the imbalance of stakeholder groups in the standards-setting process. In order to avoid the risk of oriented-standards and maintain its own legitimacy, the European ruling power should in fact integrate all the stakeholders' interests (Apple 1995, Noël *et al.* 2010, Crawford *et al.* 2013). The G-20 share the same concern and for this reason have issued a number of calls on the need for adjusting the governance of the IASB. In their September 2009 meeting, the G-20 emphasized that IASB “*should improve the involvement of stakeholders, including prudential regulators and the emerging markets*” (G-20 2009). The success of the European Union in reinstating power over the international standards-setting process is crucial to the development of more balanced governance of international economic activity. There is wide consensus that, while increasing privatization was the general trend in recent years, the global financial crisis calls for this trend to be reversed and, therefore, for the backing of public actors (e.g. Kerwer 2007, Botzem 2008, Bengtsson 2011).

In recent times, the European Union has become aware that “*accounting policy choices have an impact on the public interest and so our choices in this area need to be carefully*

¹² For instance, a certain number of states, including Italy, Greece, the Czech Republic, Estonia, Slovakia, Slovenia, also require IFRS for separate financial statements.

thought through” (European Commission 2013a). One step in the direction of restoring control over the standards-setting process is represented by the Commission’s choice to reject the option to adopt IFRS for small and medium enterprises in the European Union, and to make changes to their financial reporting through the European Directive 34/2013. The tool of the European Directive has been considered to be more flexible and to better serve the accounting needs of small and medium-sized companies, which are the backbone of the European economy and the main job creators in the European Union (European Commission 2013b).

In conclusion, this paper calls for a wider debate on financial reporting policies and their effects on the socio-economic system, which should be framed in the light of the Lisbon Treaty’s principles inspiring the European Union institutions and their behaviour. Today it is fair value reporting, but new controversial issues are looming large. One relates, for instance, to environmental issues, which are exposed to important political choices with outcomes for the global environment. With respect to petroleum resources, prospecting and evaluation, several scholars have in fact already raised a number of doubts about the legitimacy and ethics of the IASB’s work (e.g. Noël *et al.* 2010, Thistlethwaite 2011).

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